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No. 86-44

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

SHEARSON/AMERICAN EXPRESS INC. and
MARY ANN MCNULTY,

Petitioners,

v.

EUGENE MCMAHON, JULIA MCMAHON, individually and as trustees of THE DAVID J. HODDER & SON, INC. EMPLOYEE PENSION PLAN; THE DAVID J. HODDER & SON, INC. PROFIT SHARING PLAN; THE LAURIE FUNERAL HOME, INC. EMPLOYEE PENSION PLAN; and THE LAURIE FUNERAL HOME PROFIT SHARING PLAN,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

REPLY BRIEF OF THE PETITIONERS IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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ARGUMENT

Respondents in their Brief in Opposition examine the direct conflict among the circuits regarding the arbitrability of § 10(b)[1] claims and conclude that there exists only an "apparent conflict", which "is neither substantial nor important enough to warrant this Court's plenary review." Brief in Opposition ("Opp.") at 7. This strained conclusion defies comprehension. While respondents correctly concede that the conflict between the Second Circuit and the Eighth Circuit Courts of Appeals serves

[1] Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78a *et seq.* (1982).

as an independent basis for this Court to grant a writ of certiorari to review the arbitrability of § 10(b) claims, they incorrectly downplay the significance of the conflict and ignore the fact that this Court's review is also warranted because the Second Circuit decided important questions of federal law which have not been, but should be, settled by this Court. *See* U.S. Sup. Ct. Rules 17.1(a) and (c), 28 U.S.C.A. This Court has never expressly ruled on the application of the United States Arbitration Act[2] to § 10(b) claims, notwithstanding respondents' contention to the contrary. Opp. at 4-6.

The need for immediate resolution of the conflict created by the Second Circuit in *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2d Cir. 1986), and the Eighth Circuit in *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92, 815 (8th Cir. July 9, 1986), has increased since the Petition was filed with this Court on July 14, 1986. On July 17, 1986, the Ninth Circuit Court of Appeals in *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986), held that § 10(b) claims are not arbitrable. This decision creates a direct conflict with the Eighth Circuit Court of Appeals in *Phillips*, which concluded eight days earlier that § 10(b) claims are arbitrable. Furthermore, on August 11, 1986, the Third Circuit Court of Appeals in *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Nos. 85-3282, 85-3311 and 85-3343 (3d Cir. Aug. 11, 1986), adhered to its controlling precedent that § 10(b) claims are not arbitrable, also creating a direct conflict with the Eighth Circuit.

In addition to the conflict among the circuits which exists as to the arbitrability of § 10(b) claims, the Third Circuit Court of Appeals on August 11, 1986, in *Jacobson*, expressly rejected the *American Safety* rationale [3] underlying the Second Circuit's holding in *McMahon* that RICO claims [4] are never arbitrable,

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[2] 9 U.S.C. § 1 *et seq.* (1982).

[3] See American Safety Equip. Corp. v. J.P. Maguire & Co., 391 F.2d 821 (2d Cir. 1968).

[4] Claims brought under § 1964 of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961 *et seq.* (1982).

and held that RICO claims are arbitrable except in those situations where the underlying predicate offenses are not arbitrable. As the Third Circuit stated, their holding creates a direct conflict between the Second Circuit and the Third Circuit regarding the issue of RICO's arbitrability:

> Our holding that RICO claims based on nonarbitrable predicate offenses are not arbitrable conflicts with the holding of the Court of Appeals for the Second Circuit in *McMahon v. Shearson/American Express Inc.*, 788 F.2d 94 (2d Cir. 1986).

Jacobson, slip op. at 7.

The issues presented in the Petition are at least as important as any of the arbitral issues this Court has reviewed in recent years. *See Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 105 S. Ct. 1238 (1985) (whether arbitrable pendent claims may be "intertwined" with non-arbitrable claims in the same forum); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346 (1985) (arbitrability of antitrust claims in international context); *Southland Corp. v. Keating*, 465 U.S. 1 (1984) (enforceability of California franchise law which invalidated arbitration agreements); *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983) (propriety of staying a federal action in deference to a parallel litigation in state court); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974) (arbitrability of § 10(b) claims in international context); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (whether federal court or arbitrator is to resolve claim of "fraud in the inducement" of a contract). Accordingly, petitioners submit that the arbitrability of § 10(b) and RICO claims are issues warranting this Court's immediate plenary review.

I. The Fully Developed Conflict Among the Circuits Regarding the Arbitrability of § 10(b) Claims Warrants Immediate Resolution by This Court

In support of their argument that the conflict created by *Phillips* is "neither substantial nor important", respondents stress the fact that numerous other circuit court decisions have, unlike the Eighth Circuit in *Phillips*, ruled that § 10(b) claims are not arbitrable. Opp. at 7. This argument is superficially appealing but lacks substance. All but two of the circuit courts of appeals

which have addressed this issue since this Court's decision in *Byrd* have simply followed controlling precedents that were established at a time when it was assumed that this Court's holding in *Wilko*[5] extended to Exchange Act claims. These precedents were all established prior to this Court's recent holdings in *Byrd* and *Mitsubishi*, which reaffirmed the strong national policy favoring arbitration and enunciated strict guidelines to be followed when construing a statute's arbitrability.

For example, in *McMahon*, the Second Circuit's deference to its controlling precedent is evidenced in the following passage:

> Although *Scherk* and *Byrd* may cast some doubt on whether the Supreme Court, if presented with the issue, would hold claims under § 10(b) and Rule 10b-5 to be non-arbitrable, it would be improvident for us to disregard clear judicial precedent in this Circuit based on mere speculation.

McMahon, 788 F.2d at 98.

In *Miller v. Drexel Burnham Lambert, Inc.*, 791 F.2d 850 (11th Cir. 1986) (per curiam), the Eleventh Circuit Court of Appeals, in holding § 10(b) claims non-arbitrable stated:

> Under the rule of *Belke* [*v. Merrill Lynch, Pierce, Fenner & Smith*, 693 F.2d 1023 (11th Cir. 1982)], *supra*, no claims based on the federal securities acts are arbitrable. . . . *Belke* remains the law of this circuit. . . .

Id., at 854.

In *King v. Drexel Burnham Lambert, Inc.*, No. 85-1717 (5th Cir. May 28, 1986), the Fifth Circuit, in a two-page opinion held:

> The rule in this Circuit is clear: The doctrine of *Wilko v. Swan*, . . . which holds that any agreement to

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[5]*Wilko v. Swan*, 346 U.S. 427 (1953).

> arbitrate claims arising under the Securities Act of 1933 is invalid, is equally applicable to claims arising under the Exchange Act of 1934, ... Our decisions in *Sawyer* and *Sibley* retain their full precedential authority, authority we are *obliged* to follow.

Id., slip op. at 2-3. (citation omitted) (emphasis added).

In *Jacobson*, the Third Circuit considered itself bound by precedent holding § 10(b) claims not arbitrable. The Third Circuit held that their precedents of *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976), and *Moran v. Paine, Webber, Jackson & Curtis*, 389 F.2d 242 (3d Cir. 1968), precluded them from holding § 10(b) claims arbitrable. *Jacobson*, slip op. at 12-14. Therefore, the assumption that the doctrine of *Wilko v. Swan* (claims under § 12(2) of the Securities Act of 1933 not arbitrable) mechanically applies to § 10(b) claims has unfortunately retained vitality, primarily because most of the circuit courts of appeals feel powerless to hold otherwise absent this Court's intervention.

In reality, only the Eighth Circuit in *Phillips* and the Ninth Circuit in *Conover* have examined the issue of § 10(b)'s arbitrability free from the restraint of prior controlling precedent and in light of this Court's recent holdings in *Byrd* and *Mitsubishi*. These circuit courts of appeals are in direct conflict over the merits of this issue. For example, the Ninth Circuit in *Conover*, as well as respondents in their Brief in Opposition, cite a 1979 SEC release requiring broker-dealers to notify their customers that they have a non-waivable right to a judicial forum in certain instances, in support of the contention that § 10(b) claims are not arbitrable. 794 F.2d at 524; Opp. at 21-22. The Eighth Circuit in *Phillips* expressly disagreed stating:

> . . . [I]n adopting Regulation 15c2-2 the SEC intended only to reflect what it believed to be a settled principle of law (i.e. that predispute arbitration agreements

> are unenforceable under both the 1933 Act and the 1934 Act). As this opinion indicates, the SEC was mistaken.

Phillips, Fed. Sec. L. Rep. ¶ 92,815 at 93,991 n. 17.

Additionally, the Ninth Circuit and respondents conclude that language in a House Conference Report to the 1975 amendments to the Exchange Act evidences Congressional intent to preclude arbitration of § 10(b) claims. The House Conference Report dealt solely with member firm arbitration, and contained a sentence stating that it "did not change existing law, as articulated in *Wilko v. Swan*." *Conover*, 794 F.2d at 524, *citing* H.R. Rep. No. 229, 94th Cong., 1st Sess. 111, *reprinted in* 1975 U.S. Code Cong. & Ad. News 321, 342; *see* Opp. at 14-15. The Eighth Circuit, in expressly rejecting this argument, declined to give weight to what it labelled a single "ambiguous sentence". *Phillips*, Fed. Sec. L. Rep. ¶ 92,815 at 93,991 n. 17. *Cf. Hirschey v. F.E.R.C.*, 777 F.2d 1, 7-8 (D.C. Cir. 1985) (Scalia, J., concurring) (criticizing routine deference to the detail of congressional committee reports).

The result of the clear and direct conflict among the circuits is best expressed by the Eighth Circuit:

> We believe . . . that the Supreme Court's opinions in *Scherk* and *Byrd* have invited a reexamination of the applicability of *Wilko* to claims arising under section 10(b) of the 1934 Act and Rule 10b-5. Because we are not bound by the precedents of other circuits, we are free to make a new assessment of this issue. We have made that assessment, and now create a conflict within the circuits. We assume the Supreme Court will eventually decide this question.

Phillips, Fed. Sec. L. Rep. ¶ 92,815 at 93,992.

Moreover, as Judge Adams noted in his dissent to the Third Circuit's opinion in *Jacobson*:

> Because of the split in the circuits and the reservations in *Scherk* and *Ayres*, however, some uncertainty

> necessarily will remain until the Supreme Court speaks authoritatively to this issue. Since commercial relations affecting thousands of investors and scores of brokerage houses will remain in the shadow of doubt until then, an early definitive decision by the Supreme Court would be a helpful development.

Jacobson, slip op. at 23-24 (Adams, J., concurring in part and dissenting in part).

Although the circuit courts of appeals have fully developed the issue of the arbitrability of § 10(b) claims, they are powerless to resolve the conflict. Only this Court can end the imbroglio, and it should do so without delay.

II. The Third Circuit's Recent Decision in *Jacobson* Has Created a Conflict Between the Second and Third Circuits Regarding the Arbitrability of Civil RICO Claims

Respondents, in their Brief in Opposition, argue that RICO claims should be exempt from the United States Arbitration Act citing general "public policy concerns" and concluding, without any support whatsoever, that Congress "explicitly" intended that RICO claims should not be arbitrated. Opp. at 16-19. This argument is unsupported by the RICO statute, its legislative history or this Court's precedent.

The same arguments raised by respondents were recently rejected by the Third Circuit Court of Appeals in *Jacobson*, which, within days of respondents' filing of their Brief in Opposition, examined and rejected the "public policy" rationale of *McMahon* and created a conflict between the circuits regarding the issue of RICO's arbitrability. *Jacobson*, slip op. at 14-15. The Third Circuit in *Jacobson* expressly noted the lack of Congressional intent to prohibit arbitration of RICO claims and held that all RICO claims are arbitrable unless based upon non-arbitrable predicate acts. *Id*. Accordingly, the Third Circuit held that RICO claims predicated upon mail fraud or wire fraud are arbitrable. However, as an exception to its general rule that all RICO claims are arbitrable, the Third Circuit held that RICO claims

predicated on violations of § 10(b) cannot be arbitrated due to its controlling prior precedent that § 10(b) claims are not arbitrable. *Id.* at 15-16. As the Third Circuit stated, its holding "conflicts with the holding of the Court of Appeals for the Second Circuit . . .," which held that all civil RICO claims are not arbitrable because of public policy considerations. *Id.* at 7 n.2, 14-15.

The conflict created by the Third Circuit further mandates review by this Court because its decision will cause even more confusion among the lower courts. The result of the *Jacobson* holding is that when a plaintiff in a federal securities case alleges violations of state and common law, § 10(b) and RICO based upon mail, wire and securities fraud, as is commonplace: (1) his § 10(b) claim will be heard in a federal court; (2) his state and common law claims will be heard in an arbitral forum; (3) his RICO claim based on § 10(b) violations will be heard in federal court; and (4) his RICO claim based on mail and wire fraud will be heard in an arbitral forum. This result, with its attendant motion practice and collateral estoppel problems, wastes the precious and limited resources of the federal court system, greatly increases the cost and time expense of litigants, and exacerbates the disorder already present in the lower courts. The situation will continue to worsen with the passage of time, and only this Court can resolve the problem.

III. Respondents' Arguments Concerning the Enforceability of Their Various Arbitration Agreements Should not be Considered by This Court

In a misguided effort to cause this Court to deny petitioners' request that a writ of certiorari issue to review the arbitrability of § 10(b) and RICO claims, respondents claim that the arbitration agreements they entered into with petitioners are unenforceable. Opp. at 20-22. This argument was summarily dismissed by the Second Circuit in a footnote. *McMahon*, 788 F.2d at 99 n.6. More importantly, respondents concede that "[t]he evidence that the purported agreements herein were induced by fraud was not before the district court below...." Opp. at 22. For that reason alone, this Court should not address this issue.

In *Byrd*, the respondent made a similar attempt to circumvent the merits of the case by arguing that the arbitration agreement was a product of an adhesion contract and thus unenforceable. As this Court ruled:

> Respondent Byrd also argues that as a contract of adhesion this arbitration agreement is subject to close judicial scrutiny, and that it should not routinely be enforced. Byrd did not present this argument to the courts below, and we decline to address it in the first instance. We therefore express no view on the merits of the argument.

Byrd, 105 S. Ct. at 1240 n.2.

Since the respondents failed to present the district court with any evidence to preclude the enforceability of the arbitration agreements, this point in opposition should not be considered.

CONCLUSION

For all of the foregoing reasons, petitioners respectfully request that this Court issue a writ of certiorari in this case to review the decision of the United States Court of Appeals for the Second Circuit.

DATED: NEW YORK, NEW YORK
August 28, 1986

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